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PP RUEHCN RUEHGH RUEHVC
DE RUEHBJ #1556/01 1610708
ZNR UUUUU ZZH
P 100708Z JUN 09
FM AMEMBASSY BEIJING
TO RUEHC/SECSTATE WASHDC PRIORITY 4435
RHMFIUU/DEPT OF ENERGY WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDOC/DEPT OF COMMERCE WASHDC
INFO RUEHOO/CHINA POSTS COLLECTIVE
RHEHNSC/NSC WASHDC

UNCLAS SECTION 01 OF 04 BEIJING 001556

SIPDIS
SENSITIVE

TREASURY FOR OASIA/DOHNER
USDOC FOR 4420, 5130 and 6510
STATE PASS USTR FOR STRATFORD

E.O. 12958: N/A
TAGS: [ECON](#) [ETRD](#) [EINV](#) [EDEV](#) [CH](#)

SUBJECT: China/Economic Rebalancing: New Growth
Model Needed to Avoid Stagnation

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¶1. (SBU) SUMMARY. China's export-dependent growth model has served it well, but that model has now reached its limits, according to locally-based foreign economists. Domestic consumption could fuel future growth but it will take many years -- even decades -- to achieve the fundamental economic reforms necessary, including provision of a comprehensive social safety net, achieving increased rural incomes, developing a middle-class that extends beyond the major cities, and building a much larger services sector. Increasing productivity through competition and financial sector reform could help China avoid economic stagnation in the medium term. While Chinese policymakers are aware of the need for such reforms, there is some question as to whether they have the political ability and will necessary to realize such fundamental changes. Certainly at the moment, Beijing appears more concerned with stimulating short-term growth through government-led investment. The economists expressed concern that the very success of the stimulus plans in restoring growth could lead to complacency and slow--or possibly even stymie--vital reforms. With reform, China could be able to achieve growth rates in the 7 percent range; much slower than over the past decade, but fast enough to preserve social stability. END SUMMARY.

¶2. (SBU) On May 4, 2009, World Bank Director David Dollar, Dragonomics Managing Director Arthur Kroeber, and Peking University's Guanghua School of Management Professor Michael Pettis participated in a roundtable at the Embassy during the annual Economic Reporting Conference and discussed the economic challenges China faces following the global economic downturn.

Domestic Consumption Must Drive Future Growth

¶3. (SBU) Dollar commented that China had done well using the "Asian" development model, where state-encouraged investment in industrial capacity created excess production that was absorbed by foreign markets through exports. In part, this model succeeded because U.S. consumption had been driving rapid import growth. Now, however, due to the

financial crisis, U.S. import demand has declined, presenting a dilemma for China's economic planners.

¶14. (SBU) Pettis agreed that U.S. consumption will grow more slowly than GDP, causing the overall U.S. trade deficit to fall -- although it was hard to determine the short-term impact on the bilateral U.S.-China trade balance. At the moment, China's trade surplus remains high. This, according to Pettis, is not sustainable. As foreign trade deficits contract and global demand declines, China's trade surplus must also contract. He estimated that the United States' ability to absorb China's excess production was "dead for the next six years," nor could Europe be counted on as an importer of last resort if China continues to produce more than it can consume. Pettis, therefore, proclaimed "the death of the Asian economic development model" for China. Pettis stated that future Chinese growth must be driven by domestic consumption.

Income Redistribution and Liberalization Important

¶15. (SBU) All three commentators noted that China needs basic social safety nets to encourage consumption, but noted that other reforms were also important. Kroeber explained that Chinese consumers were still poor, with the per capita GDP of around USD 3,000 per year. He noted that the returns from economic and productivity growth fell disproportionately to corporations; this money

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needed to be redistributed to households for consumption. Dollar too stated that, although the household saving rates were high, the big change came from increasing enterprise savings, and household income as a share of GDP had been declining. For China to develop a more consumption-driven growth model, incomes as a portion of GDP needed to rise.

¶16. (SBU) Kroeber and Dollar added that in a consumption economy, producers must be able to move goods efficiently within the country. They advocated major reform and opening up of the distribution, logistics, and transportation sectors. Dollar emphasized the need to remove regulatory and local monopoly barriers to internal movement of goods.

¶17. (SBU) Beyond increasing consumption, the observers noted that China needs to find a way to increase productivity without relying on investment in production. Dollar commented that China needed a more developed, open services sector. Kroeber added that China needs more competition in non-competitive sectors such as services, but also in certain resource and energy sectors. He said 2008 was the year in which China's manufacturing peaked as a share of GDP. Pettis argued that reform of the financial sector was necessary to increase China's productivity. China's stock market is not good at allocating capital because the lack of transparency and structure of the market encourages speculation; a solid governance framework and sound financial data do not exist. Kroeber agreed that China must liberalize its financial sector, eliminating restrictions on capital flow among provinces.

Transition Politically Difficult

¶18. (SBU) Kroeber said that, although policymakers in Beijing increasingly accept that Chinese growth can no longer rely on external demand, unfortunately

there is currently little evidence of serious action by Beijing to transition the economy to one driven by domestic consumption.

¶19. (SBU) Kroeber opined that China's leaders had accepted somewhat lower efficiency implied by a large state-owned sector as the price for maintaining social control over certain politically-important sectors. He acknowledged that significant political barriers to reform and deregulation exist in a state-run economy. Pettis pointed out, for example, that significant financial reform implied significant political reform. Control of the financial system allows wider control of the economy.

¶10. (SBU) Dollar noted that leaders at the central and local levels are more concerned with public opinion, leading to what he called the "democratization" of policy making. He noted that earlier leaders were bolder risk takers, offering as an example Zhu Rongji's reform of the state sector in the late 1990s. Now, he said, the leadership bases their decisions on broad public opinion, making bold reform initiatives less likely.

Moving in the Wrong Direction?

¶11. (SBU) Pettis noted that when the U.S. faced the need to devolve away from a heavy reliance on exports in the 1920s, the transition took twenty years and was not smooth. China, like the United States before it, is responding to the drop in external demand by increasing investment and retaining workers, rather than decreasing production capacity as necessary.

¶12. (SBU) Pettis thought that China's massive new lending was being misallocated. In part, these loans might go to increased production capacity.

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Alternatively, the misallocation of funds would significantly increase non-performing loans (NPLs), he thought. He offered the example of the large state-owned enterprise AVIC, which reportedly has taken out loans worth USD 35 billion, but has no immediate need for the money and now has to find projects. Because the cost of failed corporate loans would ultimately be assumed by the taxpayers (through government bailouts) or small depositors (through suppressed deposit rates), these NPLs would suppress domestic consumption in the future. Pettis predicted a difficult decade: "not the hard landing, not the soft landing, but the long landing."

¶13. (SBU) Dollar was less concerned about overinvestment as a result of the stimulus plan. He agreed that investment -- and in particular government-led infrastructure investment -- was currently driving economic growth. However, he said the infrastructure projects were aimed at improving consumption, such as high-speed passenger rail and urban public transport. Dollar, however, was concerned that the state sector was crowding out the private sector and predicted that this will not create an environment for productive private investment.

Disagreement on Future Prospects

¶14. (SBU) Dollar's main concern was that the early results from China's stimulus plan were so good that Beijing could lose enthusiasm for further reforms. To increase the share of household income as a portion of GDP, China must reform many sectors, but

Dollar commented that he was not impressed with progress and was concerned about complacency. He thought if Beijing relied exclusively on its fiscal stimulus and monetary loosening, China might face a "W" shaped double-dip recession. Further, attempts to recapture the past and stimulate exports would be a detrimental approach for China. Dollar saw a decade of stagnation if China did not reorient its economy towards domestic demand.

¶15. (SBU) Kroeber shared the same concerns about the Chinese government becoming complacent due to a fairly successful stimulus program. Kroeber thought the stimulus program was in part a propaganda exercise to support consumer confidence in the face of a fundamental external shock. He was fairly confident moving forward that Beijing would find a way to muddle through the transition. He highlighted the fact that there already has been a shift towards a consumer-driven economy, that the government has made a commitment to a national healthcare program, and that the percentage of the budget directed at social services should increase. Although confident that Beijing would reorient the economy in the next few years, Kroeber noted that future growth rates would be much lower, probably around seven percent. This was because, without exports and foreign investment, China's productivity growth rate would decline, while Beijing's reliance on the state-owned sector further hinder efficiency. Mitigating this somewhat was the government's recognition of the benefits of competition for productivity growth and long term economic growth. In addition, the downturn was weeding out weaker companies, particularly in the export sectors, which should be good for future growth. Kroeber stated, "at the end of the day, they will come around to keep growth and to keep growing at a solid clip."

¶16. (SBU) Pettis offered the most pessimistic assessment of China's future growth. He said that Beijing's central bankers and Ministry of Finance officials knew what needed to be done but didn't have the power to effect the necessary changes. He suggested that reasonable academics also knew that China needs to appreciate the Renminbi, liberalize markets, and allow workers to organize, but remained pessimistic that the government could implement such

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reforms. According to him, China has needed to reduce its demand on export-led growth by increasing domestic demand for years, and yet Beijing has not proactively addressed these problems. Pettis also expressed concerns that China's policies would result in trade friction, which would disproportionately hurt China.

Social Stability Not an Issue

¶17. (SBU) None of the commentators felt that the current economic downturn would result in social instability. Pettis shared his opinion that social instability does not stem from unemployment, but rather it usually occurs when there is a significant split in the leadership. He stated that the current economic crisis has brought factions together.

¶18. (SBU) Kroeber agreed, stating that lower growth -- for example in the achievable range of seven percent -- was all that was necessary to meet China's employment needs. He said that, although Chinese citizens and policymakers were accustomed to ridiculously high growth rates, the country would operate a perfectly successful society at a lower growth rate.

Comment

¶19. (SBU) Most foreign observers and a growing majority of Chinese economists and policymakers concede that China has outgrown an export economic model and needs to reorient its economy towards domestic-demand driven growth. The current debate within China is over the reforms necessary to achieve this fundamental reorientation of the economy, with some advocating state-led growth and others pressing for more market-oriented reform. Complicating matters are the large and powerful special interest groups that have grown up around the current investment- and export-oriented regimes, seeking to preserve jobs and profits within these formerly-favored sectors. We are seeing signs that the government, while not moving boldly, would like to enact the policies necessary to create a strong, self-propelling domestic economic system. The question for most outside observers remains whether China can realize the necessary level of reform with enough speed to prevent a prolonged period of below-potential growth.

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